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SUBJECT: CHINA/OVERCAPACITY: OVERWEIGHT OR HEALTHY BABY FAT?

Refs: A. Beijing 2952; B. Hong Kong 2124; C. Shanghai 0273.

1. (SBU) SUMMARY: China's industrial structure is extremely overcapacity and the recent massive government stimulus packages and credit expansion exacerbated the problems, according to a November 26, 2009 EU Chamber of Commerce report. The report stirred controversy in China's blogosphere and media with its claim that excess capacity fueled trade protectionism, and was soon followed by a Chinese government press conference outlining the government's measures to combat overcapacity. Economists, academics, and policymakers agreed industrial overcapacity was a serious and pervasive problem in China, although difficult to evaluate on an industry-level basis. While the recent fiscal and monetary stimulus plans increased investment, there was little consensus on whether the majority of funding went to fuel infrastructure projects or further industrial overcapacity. Chinese observers hoped overcapacity would not lead to trade disputes, but the EU Chamber of Commerce's president noted a series of trade remedy cases currently making their way through the European system. END SUMMARY.

EU Chamber Report: Overcapacity a "blight"

2. (SBU) The Beijing-based European Union Chamber of Commerce on November 26, 2009 released a report, "Overcapacity in China," charging that Chinese industrial overcapacity was a "blight on China's industrial landscape... wrecking far-reaching damage on the global economy in general and economic growth in particular." The report stated that Chinese industrial overcapacity would lead to trade disputes as other economies sought to protect their markets. It investigated six industries that the Chinese government had identified as suffering from over-capacity: steel, aluminum, cement, chemicals, refining, and wind power equipment.

3. (SBU) The authors attributed overcapacity to several "key recurring factors," namely:

- high retained earnings (i.e. excess profits) by State-Owned Enterprises (SOEs)
- collapse of export-market demand
- low domestic consumption due to low incomes
- weak enforcement of regulations and health/safety standards
- artificially low input prices
- artificially low capital costs
- artificially low technology costs
- incentives to local governments to attract investment
- local protectionism and regionalism
- an over-emphasis on market share over profitability.

Report Provokes a Harsh Reaction

4. (SBU) EU Chamber President Joerg Wuttke admitted to Econoff that

the report was timed for release just before the EU-China Summit, and had provoked an unexpectedly strong reaction from both the foreign and domestic media. Chinese state media and netizens lashed out at the concept that such excess production could result in trade protectionism. The Global Times warned flatly: "Do not blame trade protectionism on China's excessive productivity." Blogs such as EEO, Huachen, Wang Yi, and Jin Rong Jie acknowledged that overcapacity has been a problem for years, especially in the six industries Chen Bin, Director of the Department of Industry at China's National Development & Reform Commission (NDRC) committed to curbing in October: steel, cement, plate glass, coal-chemicals, polycrystalline silicon, and windpower equipment. Bloggers, however, called the EU Chamber's assertion that overcapacity would lead to global trade disputes "inaccurate" and "absurd." And the Chinese government reacted quickly: the NDRC and Ministry of Industry and Information Technology (MIIT) held a press conference in Beijing on December 3, 2009, announcing new, stricter guidelines to control overcapacity in steel, cement and flat glass.

But Is Overcapacity Really a Problem?

15. (SBU) Within a specific industry, and even with excellent data sets, measuring overcapacity was challenging, analysts told EconOff. Steven Watson, Chairman of Capital Research and Management's China Business Group, explained to Econoff that his staff had been looking at the Chinese steel sector in great detail, but had been unable to determine whether China's current excess capacity is a long-term systemic problem, or a cyclical downturn resulting in a dip in demand, implying that China will grow into its current capacity. Similarly, Dragonomics Research Managing Director Arthur Kroeber noted that it was possible many companies were "just a little bit

BEIJING 00003349 002 OF 003

ahead of growing demand." Kroeber cited the auto industry as a case where many analysts thought the major players were producing at too high volumes, but later revised their opinion when new cars were still rolling off the lots. China Academy of Social Sciences (CASS) Researcher Liu Feng opined that traditional industries, such as iron, steel and cement suffered from overcapacity, but commented that new industries, such as wind and solar power, may not be over capacity. Moreover, Chinese industrial overcapacity was temporary, he said, and just an issue during this period of rapid development: "People should see the problem from a developing country perspective."

16. (SBU) Taking a more macroeconomic, economy-wide view, however, most economists agreed that excess investment had led to excess capacity. World Bank Economist Louis Kuijs told Econoff that government policies led to increased capacity, such as direct stimulus money, subsidies to energy, lax environmental regulation, and over-accommodating local officials. Stephen Green, an analyst with Standard Chartered, agreed that the stimulus package had encouraged new capacity, especially in the cement industry where new facilities are easily constructed. Green echoed Kuijs' main reasons for overcapacity: "artificially low energy and land prices, local protectionism, and the lack of a proper framework for mergers and acquisitions do indeed facilitate the building of more and more heavy industrial capacity." UBS Economist Wang Tao added another factor, noting that local officials were evaluated by their locality's GDP growth rates, and capital-intensive growth tended to be faster, creating an incentive for lowering the costs of such investment.

Does the Stimulus Investment Exacerbate It?

17. (SBU) CASS's Liu noted that much of the stimulus was aimed at earthquake reconstruction and infrastructure projects like light rail, subways and roadways. Additionally, infrastructure investments in Western provinces such as Gansu and Qinghai may be underused at present, but it was widely believed they would be utilized in the future. UBS's Wang Tao agreed that China could still utilize large amounts of infrastructure investment. She asserted that, given China's size, population, and rapid growth, China did not have too much infrastructure. She went on to compare

China's transportation infrastructure with the United States at similar stages in development, arguing that China could still make productive use of large infrastructure investments. Dragonomics' Kroeber agreed China had huge infrastructure needs and this spending had not been wasted. As hundreds of millions of people moved to the cities, they would require much more infrastructure. Some funded projects were anticipatory, but at worst China had "borrowed" some future growth by front-loading infrastructure spending.

18. (SBU) The World Bank's Kuijs, on the other hand, argued that much of the Chinese stimulus program was not simply infrastructure investment but rather a more accommodative lending environment. He saw the recent global economic crisis policy environment as exacerbating overcapacity because it led to very easy access to credit in China. Extremely fluid capital led to "worrisome" increases in investment even in industries where domestic demand had not increased. IMF's Vivek Arora also worried that credit was flowing to certain industries already burdened with overcapacity. While unconcerned about loans extended to households and infrastructure projects, he was unable to determine the destination for almost two-thirds of the stimulus-fueled credit expansion. (Note: in a recent meeting with U.S. visitors, a Chinese banker admitted that that new bank lending often flowed to industries with overcapacity, despite careful guidance from Beijing on the types of business allowed to receive loans. End note.)

Stimulus Indirectly "Fuels the Trade War Fire"

19. (SBU) Kroeber asserted that it may have been true in the late 1990s that excess consumer goods and textiles were dumped on the international market. However, not all current overcapacity led to trade disputes, he cautioned. Instead, the problem was one of scale. For example, even if only 10 percent of steel produced in China was for export, that approximately 60 million tons was still "an astonishing figure that influences global prices and markets." Kroeber added that Chinese policymakers were not used to thinking about their policy impacts on global markets. They were, however, used to the reverse, playing victim to international influences.

110. (SBU) CASS researchers Lu Tie and Li Xiaohua disagreed with the claim that excessive Chinese productivity directly led to global

BEIJING 00003349 003 OF 003

trade disputes: "It is hard to say how much the stimulus packages fan the trade war fire. This is another excuse for trade protectionism." However, CASS researchers agreed that excessive productivity in certain industries pressured exports. Economic recovery would alleviate the situation, even though official data showed Chinese industry has about a 60 percent reliance on exports.

111. (SBU) EU Chamber President Wuttke disagreed strongly, suggesting that the world would see many anti-dumping cases against China coming from the European Union. "Eleven are in the works," Wuttke claimed.

HUNTSMAN